The Investor’s Guide to Economic Fundamentals

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The Investor’s Guide to Economic Fundamentals

John Calverley
To Aileen
# Contents

List of Figures xiii

List of Tables xv

Preface xvii

Acknowledgements xix

**PART I ECONOMICS FOR INVESTORS** 1

1 **Why Economic Growth Matters** 3  
   Trend versus cycle 3  
   Measures of growth 3  
   Expanding economies 5  
   Defining gross domestic product 7  
   Four ways to analyse GDP 8  
   Key controversy: Economic growth and the ‘new economy’ 12  
   Conclusion: Growth fundamentals and the investor 13

2 **Business Cycle Fundamentals** 15  
   A typical business cycle described 15  
   Investment and the cycle 19  
   The inventory cycle 19  
   The US 1980s cycle: 1982–90 20  
   The current cycle 2002– 25  
   Two approaches for investors 25  
   The role of leading indicators 26  
   How do depressions fit in? 26  
   Why does the cycle exist? 27  
   Where does the recovery come from? 27
Contents

Kondratieff Cycles 28
Conclusion: Business cycle fundamentals 28

3  Is Inflation Dead? 29
   The Phillips curve 29
   What causes inflation? 29
   Inflation targeting 30
   Why did inflation pick up in the 1960s? 30
   Indicators of inflation 31
   Measuring the forces determining inflation 32
   Implications of a low inflation environment 35
   Inflation and investment returns 35
   The threat of deflation 36
   Conclusion: Inflation remains fundamental 37

4  The New Economy: Myth or Reality 39
   Faster productivity growth 40
   Better inventory control eliminating recessions 42
   Permanently lower inflation 42
   Conclusion: Outlook for the new economy 44

5  Understanding Central Banks 47
   What are central banks trying to do? 47
   Independent central banks and inflation targeting 48
   Official interest rates 49
   The yield curve 49
   Interest rates and the economy 51
   Assessing the policy stance 51
   The Taylor Rule 53
   Monetary conditions indices 54
   The monetarist view 54
   Monetary policy and the exchange rate 58
   Conclusion: Monetary policy fundamentals 58
   Appendix: How is money created? 59

6  Fiscal Policy 61
   Measuring the stance of fiscal policy 61
   The UK experience 1980–2002 62
   Why fiscal policy does not always work 63
   Linkages with monetary policy 64
   The US experience 1980–2002 65
   Fiscal policy and real interest rates 66
   Fiscal policy in high-inflation countries 66
   Fiscal policy and debt 67
   Conclusion: Fiscal policies and markets 68
16 Emerging Markets Investments

Emerging stock indices
Why invest in emerging markets?
What drives emerging stock markets?
Practical issues for investors
Emerging bond markets
Analysing emerging bonds
Conclusion: Fundamentals of emerging markets

17 Commodity Markets

Commodities and economic growth
Commodity prices and inflation
Commodity prices and interest rates
Precious metals
Fuels
Industrial raw materials
Foods and beverages
Long-run trends in commodity prices
Conclusion: The fundamentals of commodities

PART III SUMMARY AND CONCLUSIONS

18 Summary: Economic Fundamentals and Market Performance

Market responses to economic events
Long-term economic holding patterns
Market performance: The historical record
Future market returns

19 Economic Fundamentals and the Investment Process

A caution from finance theory
Practical lessons from theory
Investment styles and approaches
Conclusion: Combining different approaches

20 Ten Years of Changing Fundamentals

Faster trend GDP growth?
Inflation targeting has kept inflation low
The spectre of deflation
The growing significance of asset prices
Fiscal policy makes a comeback
Globalisation
Bull market in bonds
<table>
<thead>
<tr>
<th>Contents</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>High equity valuations</td>
<td>222</td>
</tr>
<tr>
<td>Dollar strength and euro weakness</td>
<td>223</td>
</tr>
<tr>
<td>Changes in investment fundamentals</td>
<td>224</td>
</tr>
<tr>
<td>Useful Websites</td>
<td>225</td>
</tr>
<tr>
<td>Glossary</td>
<td>227</td>
</tr>
<tr>
<td>Index</td>
<td>237</td>
</tr>
</tbody>
</table>
# Figures

1.1 The US economic cycle and trend 4
2.1 US GDP growth 1980–91 20
2.2 US GDP growth 1990–2001 22
3.1 US inflation and capacity use 33
3.2 US inflation and unemployment 34
4.1 US output per hour (5-year moving average) 40
4.2 US wage growth (compensation per hour) 43
4.3 Trade-weighted US dollar index 44
5.1 US yield differentials: 10-year yield — Fed Funds rate 50
5.2 US interest rates and the economy 52
5.3 US real interest rates 53
5.4 US money growth M3 57
6.1 UK: General government balance, financial and structural, as percentage of GDP 62
7.1 USA: Household net worth/income 71
7.2 USA: Savings rate and wealth 74
7.3 Japan’s bubble 76
8.1 USA: Current account as percentage of GDP 83
11.1 US short rates and the yield curve 127
12.1 US Treasury yields: the long view 130
12.2 UK bond yields 134
12.3 UK real bond yield and inflation 134
12.4 US BB-rated spreads over Treasuries 142
13.1 US corporate earnings and the economy percentage change 146
13.2 US S&P 500 p/e ratio 148
13.3 US p/e ratio and Fed Funds rate 150
13.4 US p/e ratios and bond yields 151
13.5 US real money growth and the p/e ratio 152
14.1 US$ nominal effective exchange rate 158
14.2 US$/euro rate 165
15.1 UK: Stocks versus houses 176
15.2 UK real house prices and GDP growth 177
15.3 UK: House prices/average earnings 178
<table>
<thead>
<tr>
<th>Figure</th>
<th>Description</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>15.4</td>
<td>UK: Real interest rates</td>
<td>178</td>
</tr>
<tr>
<td>16.1</td>
<td>S&amp;P/IFC global emerging index and S&amp;P 500 (log scale)</td>
<td>184</td>
</tr>
<tr>
<td>16.2</td>
<td>Yield differential on Brady bonds (spread over 30-year US Treasuries)</td>
<td>190</td>
</tr>
<tr>
<td>17.1</td>
<td>Commodity price indices (1974 = 100)</td>
<td>194</td>
</tr>
<tr>
<td>17.2</td>
<td>US GDP growth and the CRB index</td>
<td>194</td>
</tr>
<tr>
<td>17.3</td>
<td>Commodity prices and US inflation</td>
<td>195</td>
</tr>
<tr>
<td>17.4</td>
<td>Commodity prices and interest rates</td>
<td>196</td>
</tr>
<tr>
<td>17.5</td>
<td>Gold: $ per ounce</td>
<td>197</td>
</tr>
<tr>
<td>17.6</td>
<td>Oil price: $ per barrel (Saudi light)</td>
<td>198</td>
</tr>
<tr>
<td>17.7</td>
<td>Oil price in real terms</td>
<td>199</td>
</tr>
</tbody>
</table>
# Tables

1.1 GDP growth and investment rates 6
1.2 GDP by component: USA 2000 8
1.3 Consumer spending indicators 9
1.4 Business investment indicators 10
2.1 Five phases of the business cycle 16
2.2 USA: Recoveries and the stock market 17
2.3 US leading indicators 26
6.1 Fiscal stance 2001 62
6.2 Policy mix and the yield curve 65
6.3 Public debt/GDP 2001 67
7.1 Household net wealth 72
8.1 Main items in the balance of payments 82
9.1 Correlations between stock markets 1994–9 96
10.1 Exchange rate per US dollar (end 1996 = 100) 109
12.1 Cumulative average default rates (%) 140
18.1 The effects of fundamentals on major asset classes 206
18.2 Bond and stock market returns 207
Why does the stock market rise dramatically one year and fall sharply the next? Which way will interest rates go next? Why are bond yields at today’s level? Are bonds cheap? Why is the dollar so strong? What do property yields say about the property market? What caused the Asian crisis? Will fiscal expansion work? These are some of the questions this book tries to address by looking at the economic fundamentals driving markets. It is aimed at all those engaged in investment, both market practitioners and private investors.

As a practising business economist, my job is to make sense of market levels and movements and then advise management and clients on future opportunities and risks. These pages represent an accumulated view, derived from 25 years of close observation of markets, experiencing the investment process, talking to other analysts and practitioners as well as academic study. The book aims, above all, to be a practical guide, easy to read, explaining fundamental relationships in a concise and easily digestible form.

With a good knowledge of fundamentals readers can approach any given market environment with tools that are not only timeless, but provide a guide to what is happening in a long-term and cyclical framework and contribute to a sound investment decision, with full appreciation of the risks. Even investors who use approaches that make little use of fundamental analysis — for example, indexed funds or technical analysts — can benefit from a background understanding.

Of course understanding market fundamentals does not mean that making money is easy, but it does mean that investors can recognise the recurring patterns and comprehend the risks involved. Ultimately the only way to earn more than the risk-free investment (in other words, government paper, preferably index-linked) is to take on some kind of risk, whether it be market risk or credit risk. After you read this book I hope you will have a better understanding of how to incorporate fundamentals into the investment process and how to assess these risks.

HOW TO USE THIS BOOK

This book can be read from beginning to end of course, but it is also designed to allow the reader to dip into any chapter as desired. For example, the reader interested in the fundamentals of stock markets can go straight to Chapter 13. Or if the immediate interest is in understanding monetary policy, the reader can go directly to Chapter 5. Also, in the glossary the reader will find most of the jargon that is commonly used in the markets, from arbitrage investing to yield curve. A section on websites lists some of the most useful resources, noting especially sites with good links.
The book is structured as follows. Part I (Chapters 1–10) looks at economic fundamentals for investors, to explain how economic forces combine with monetary and fiscal policy to determine interest rates, economic growth and inflation. The chapters start with economic growth and the cycle, moving through inflation, deflation and unemployment to monetary and fiscal policy. In Chapter 4 an assessment of the so-called ‘new economy’ is made. Chapter 7 discusses the feedback from asset prices to the economy and policy, an increasing area of interest to policymakers and the markets. Chapters 8–10 look at international aspects including the exchange rate, trade and globalisation and emerging markets.

Part II (Chapters 11–17) then takes each of the major asset classes in turn and explains how they are assessed using fundamental techniques. Individual chapters cover money markets, bonds, stocks, currencies, property, emerging markets and commodities.

Part III concludes with three chapters. Chapter 18 provides a summary of the main body of the book with a table showing the typical response of each asset class to economic events. Chapter 19 looks at different approaches to investment, from market timing to hedge funds and discusses how economic fundamentals are used in each case. Chapter 20 looks at how the fundamentals have changed over the last 10 years and hazards some guesses about future developments.

Although it is very much the author’s contention that the fundamentals are just that, fundamental, in practice there are substantial shifts over time, sometimes caused by changing policy approaches and sometimes due to changes in the economy. Over the last 10 years the most significant changes have been the widespread adoption of inflation targeting, the emergence of deflation, the collapse of the ‘Asian miracle’ and the emergence of historically high stock market valuations.

Throughout the book the reader will find sections focusing on a market over a specific period, for example a profile of the last US business cycle or an explanation of the Asia crisis, explaining what happened and why. Naturally, considerable attention is paid to the US economy, but the reader will also find detailed discussions of Japan, Euroland, the UK and emerging economies.

I have also included forecasts or alternative scenarios of where I think markets are going at the time of writing (April 2002). When you read this book you will be able to test these against what has actually happened. Doubtless, since markets are always full of surprises you will find plenty of differences! In a way this should be taken as a health warning of the difficulties of forecasting markets. Not only are markets frequently hit by unexpected ‘shocks’, but there are always many different forces working at the same time.

I have thoroughly enjoyed writing this book. Markets provide an endless source of interest and excitement because of the continuous process of change and evolution, and the fundamentals are always being tested by new events and new policy approaches. I hope you enjoy reading it.
I would like to thank American Express Bank for encouraging me to pursue this project. I would also like to thank my colleagues in the Global Economics Unit for their support while I was immersed in drafts as well as for their ideas and suggestions from which I have borrowed liberally. I would especially like to thank Kevin Grice for reading the manuscript and providing detailed comments, and also Sharon Thornton for patiently helping me with the charts, tables and corrections. Naturally all remaining errors and omissions are mine.
Changes in economic growth are crucial for investors. Not only do the phases of the economic cycle bring attendant moves in interest rates, bond yields, stock valuations, etc., but a faster or slower trend growth rate directly influences profits and therefore long-term stock market returns.

More fundamentally, economic growth is what distinguishes investment from gambling. Games of pure chance such as roulette, as well as games that incorporate skills such as poker or backing horses, suffer from the limitation that each person’s winnings are offset by someone else’s losses. In economics jargon, they are ‘zero-sum games’, i.e. the sum of everybody’s gains and losses is zero. Investment is different. With investment, everyone can gain, but this is true only as long as the economy continues to grow.

**TREND VERSUS CYCLE**

For as long as economics has been a subject of study economic growth has moved in cycles, with periods of fast growth interspersed with periods of slow growth or decline. Economists like to separate this cycle from the ‘trend’ or ‘underlying’ growth of the economy. The advantage of this approach is that it divides the study of economic growth into two disciplines: an analysis of the cycle and an analysis of the trend (the subject of this chapter). Chapter 2 looks at business cycles.

However, while it is convenient to split growth into two components, it should not be assumed that the trend is completely independent of the cycle. Some economists argue that a long period of recession may actually depress the trend rate of growth and vice versa. Figure 1.1 shows GDP growth for the US economy over the last 40 years and includes a 10-year moving average to indicate the long-term trend. From the early 1970s through to the mid-1990s the cycle became more pronounced while trend growth declined. More recently, however, there is evidence of faster trend economic growth in the USA, with reduced volatility, notwithstanding the sharp drop in GDP growth in 2001.

**MEASURES OF GROWTH**

Economists assess the output or production of an economy with a variety of measures but gross domestic product (GDP) is the one most commonly used. GDP measures the total value of goods and services produced in an economy, i.e. everything produced for sale to the final user. While GDP is always the most important ultimate measure, the data are usually released too late to be of value for the investor. Other data releases that give partial clues to the direction of the economy are often watched more closely because they give an earlier indication of trends.

One indicator that is scrutinised particularly closely is Purchasing Managers’ indices, renamed Supply Managers’ indices in the USA from January 2001. The US Institute of Supply Managers’ Index has been available for decades and provides a very good indicator of business
confidence in the production sector. More recently a ‘non-manufacturing’ survey has also been available. Purchasing managers’ surveys have also been instituted in Euroland and the UK over the last 10 years but they are treated with more caution by analysts because they are relatively new and have not been calibrated over several cycles. All these indices are based on a survey of ‘purchasing managers’ in companies, asking each a series of questions on his or her company’s situation, including orders, inventories, hiring plans, prices paid, etc.

Industrial production is another key indicator. Although industry accounts for only around 20–25% of GDP in most OECD countries (the main industrial countries), its output tends to be more volatile than the rest of the economy and therefore provides a good signal of overall trends. When the economy is expanding producers will often increase output faster than sales in anticipation of future sales (not wanting to miss out and confident of not being left with unsold inventory). When the economy is contracting, industrial production will usually decline much more than GDP because producers are trying to clear excess inventories. Other useful indicators of GDP are leading indicators, employment and retail sales.

For investors there are four different ways that GDP can be analysed which provide useful insights.

1. *Nominal versus real GDP*. The difference between the two is inflation, in this case as measured by the GDP price deflator. Real GDP is what counts and what can be compared across countries and across time.

2. *The demand components approach*. This looks at the various components of GDP, e.g. consumer spending, investment, government spending, net exports, etc. Each of these
components responds in different ways to changes in variables such as interest rates and exchange rates, and so economists use this breakdown as a way of analysing the likely changes in the economy. This approach is sometimes called ‘Keynesian’ after the British economist J.M. Keynes.\(^1\)

3. **Investment versus productivity.** How much of the increase in output is due to new machines (i.e. new investment) that can create more output and how much is due to better use of the existing machines (i.e. greater productivity)?

4. **Supply-side components of growth.** Growth is broken down into changes in employment and hours worked and changes in labour productivity.

These four approaches are analysed in detail later in this chapter. Note, however, that there are other approaches to GDP: for example, GDP can be broken down on the income side, so that gross domestic income is equal to wages, profits, rent and interest. Another way to cut GDP is by dividing it between agriculture, industry and services.

**EXPANDING ECONOMIES**

*Why do some countries grow faster than others?* The simplest way to answer this question is in terms of the third approach to GDP discussed above, namely investment and productivity, i.e. output per hour. The fast-growing countries of Asia have all had relatively high investment rates and high productivity growth rates. Investment here includes spending on education and skills and on infrastructure such as transport and telecommunications as well as on new factories. However, some countries have also enjoyed rapid increases in the number of hours worked due to population growth, greater female participation and, sometimes, longer hours.

What determines investment and productivity rates? Rates of investment are closely related to the level of savings. If current spending on goods and services is high, perhaps because wages are high or consumer borrowings are high or the government is running a large budget deficit, then there are less resources available for investment. If the economy is generating higher savings then it is more likely to have high investment. However, high savings by consumers and businesses are by no means certain to go into domestic investment. They might go into financing a government deficit or into investments overseas.

If high savings are to be used for productive investments, three domestic conditions must be satisfied.

First, investment is likely to be higher, the better the general business environment, which includes a whole host of factors, most of which are influenced if not determined by government policy. Hence, an economy which is moving in the direction of privatisation, reduced regulation and increased educational attainment is likely to see an expansion in investment over time. As we shall see in Chapter 10, policies of this kind in emerging markets have usually been correlated with advancing stock markets. Similarly, the buoyant stock markets of the USA and Europe during the 1990s were linked to progress in these areas.

Secondly, returns on capital should be high. If business can see high returns, then it is much more likely to invest. Return on capital, however, has not been the only motivator in many countries. In Asia investment seems to have been aimed at sales growth and market share rather than simply returns. Nevertheless the difficult experience of Japan throughout the 1990s and

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\(^1\) J.M. Keynes’ most influential work was “The general theory of employment, interest and money”, 1936, London: Macmillan. ‘Keynesian’ economics was developed by other economists using a simplified framework and the debate continues to this day on the extent to which this framework is true to Keynes.